**Office of Chief Counsel**
**Internal Revenue Service**

# memorandum

CC:LM:FSH:MAN:2:TL-N-7218-00
PLDarcy

date:

to: Territory Manager, Retailers, Food, and Pharmaceuticals
(Fairview Heights-IL)
Attn: Revenue Agent Larry Hardin

from: Area Counsel (Financial Services & Healthcare) (Area 1 - Manhattan)

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subject: [redacted]
Taxable Years Ended [redacted] and [redacted]
U.I.L. Nos. 41.51-02 and 41.51-09

EARLIEST STATUTE OF LIMITATIONS EXPIRES: [redacted]

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This memorandum responds to your request for advice on whether the research activities of [redacted] ("[redacted]") are excluded from the definition of qualified research pursuant to Section 41(d)(4)(H). The advice rendered in this memorandum is conditioned on the accuracy of the facts presented to us. This advice is subject to National Office review. We will contact you within two weeks of the date of this memorandum to discuss the National Office's comments, if any, about this advice.

## ISSUE

1. Whether the research activities of [redacted] are "funded," and thus excluded from the definition of qualified research pursuant to Section 41(d)(4)(H).

**CONCLUSION**

The research activities of [redacted] are "funded," and thus excluded from the definition of qualified research pursuant to Section 41(d)(4)(H).

**FACTS**

The Large and Mid-Size Business Operating Division (Retailers, Food and Pharmaceuticals) is currently auditing the taxable years ended [redacted] and [redacted] of [redacted], a [redacted]. During the years at issue, the shareholders of [redacted] included a partnership controlled by members of the [redacted] family and individual members of the [redacted] family.

Prior to [redacted], [redacted] performed substantial research on its own behalf to develop new products and to devise various technologies to aid in the manufacture of its products. The [redacted] technology consisted of numerous patents (both domestic and foreign), pending patent applications, unpatented technology, and associated trademarks. In [redacted], [redacted] sold its technology and associated trademarks directly to a grantor trust located in the [redacted] (hereinafter the "Family Trust"). The grantor of the Family Trust is a domestic trust whose beneficiaries are members of the [redacted] family. The ultimate beneficiaries of the Family Trust are [redacted] of the [redacted] family (i.e., [redacted]. Also in [redacted], members of the [redacted] family formed [redacted] and [redacted], [redacted] limited liability companies.

Immediately after [redacted]'s sale of its technology to the Family Trust, the Family Trust and [redacted] entered into a [redacted]. The [redacted] obligated [redacted] to provide research and development services to the Family Trust, and required [redacted] to bear all costs in connection with such research and development services. The [redacted] permitted [redacted] to delegate these obligations to [redacted].

[redacted] and [redacted] immediately entered into an [redacted]. Pursuant to the [redacted], [redacted] delegated its obligations under the [redacted] to [redacted]. Thus, the [redacted] obligated [redacted] to provide research and development services for the Family Trust and to bear all costs in connection with such research and development services. The [redacted]

also gave [redacted] the right to delegate its obligations under the [redacted] to [redacted].

[redacted] and [redacted] simultaneously entered into a [redacted]. In the [redacted], [redacted] delegated its obligations under the [redacted] to [redacted]. As a result of the [redacted], [redacted] was to provide research and development services for the Family Trust and bear all costs in connection with such research and development services. [redacted] was further obligated to acquire and defend any necessary patents, copyrights, and trademarks on all products and technology resulting from its research and development services. Although the Family Trust would own all the patents, copyrights, and trademarks, [redacted] had to bear all expenses related to the perfection and defense of these assets.

The Family Trust licensed the [redacted] technology back to [redacted]. [redacted] then licensed the [redacted] technology to [redacted]. In a license agreement between [redacted] and [redacted], [redacted] obtained an exclusive license to exploit the Family Trust's research and development results within the United States, United States territories and possessions, [redacted], and [redacted]. Under the [redacted]/[redacted] license agreement, [redacted] paid total royalties to [redacted] of approximately $[redacted] and $[redacted] during the taxable years ended [redacted] and [redacted], respectively. These royalty payments arose from two sources. The first source of royalties paid by [redacted] was for the ongoing licensing of technology that [redacted] sold to the Family Trust in [redacted]. These royalty payments comprised about [redacted] percent of [redacted]'s total royalty payments to [redacted]. The second source of royalties paid by [redacted] was for the licensing of new products created by [redacted]. These comprised less than [redacted] percent of [redacted]'s total royalty payments to [redacted] during the taxable years at issue. The royalties paid by [redacted] to [redacted] were ultimately transferred to the Family Trust through [redacted] and [redacted].

**DISCUSSION**

Section 41 allows taxpayers a credit against tax for increasing research activities. Generally, the credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's qualified research expenses for the taxable year over the base amount, and 20 percent of the taxpayer's basic research payments determined under Section

41(e)(1)(A)[1]. However, the term "qualified research" shall not include any research to the extent such research is funded by any grant, contract, or otherwise by another person. I.R.C. § 41(d)(4)(H).[2]

A taxpayer's research is funded when the taxpayer agrees to perform research for another person without retaining substantial rights to the research under the agreement providing for the research. Treas. Reg. §§ 1.41(5)(d)(2) and (3)[3]. Pursuant to Treasury Regulation 1.41-5(d)(3), a taxpayer does not retain substantial rights in the research if the taxpayer must pay for the right to use the results of the research.[4]

As a result of the [redacted], [redacted] provided research and development services for the Family Trust and bore all costs in connection with such research. To obtain the right to use the results of the research, [redacted] had to pay substantial royalties to the Family Trust through [redacted] and [redacted]. During the taxable years ended [redacted] and [redacted], paid total royalties of approximately $[redacted] and $[redacted], respectively. [redacted] argues that its research activities are not funded because it pays a below market royalty to [redacted]. However, Treasury Regulation 1.41-5(d)(3) does not require a fair market (or an above fair market) royalty to be considered funded. Thus, we do not believe

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[1] Under Section 41(c)(2), however, the minimum base amount is 50 percent of the credit year qualified research expenses.

[2] Pursuant to Section 41(f)(1)(B)(i), all trades or businesses (whether or not incorporated) which are under common control shall be treated as a single taxpayer. If [redacted], [redacted], [redacted] and the Family Trust are under common control, then 41(d)(4)(H) would not disallow the Section 41 credit. [redacted] and its representatives have strenuously argued that the entities are not under common control. Thus, we will not address the common control issue.

[3] Treasury Regulation § 1.41-5 is entitled "Qualified Research for Taxable Years Beginning Before January 1, 1986." However, despite this title, Treasury Regulation § 1.41-5 applies equally to post-1986 taxable years. Lockheed Martin Corp. v. United States, 42 Fed. Cl. 485 (1998), rev'd and rem'd on other issue, 210 F.3d 1366 (Fed. Cir. 2000).

[4] Pursuant to Treasury Regulation 1.41-2(a)(3), if a taxpayer performs research for another person and retains no substantial rights in the research (as defined in Treasury Regulation 1.41-5(d)(2)), the taxpayer cannot claim the Section 41 credit for that research.

[redacted]'s argument has merit.[5]

If you have any questions regarding the above, please contact Paul Darcy of this office at (212) 264-5473 x256.

ROLAND BARRAL
Area Counsel

By: _____
PETER J. GRAZIANO
Associate Area Counsel
(LMSB)

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[5] During our discussions with the Examination Team, we have expressed concerns about this case unrelated to Section 41. The facts indicate that [redacted] is incurring substantial uncompensated services for the Family Trust and may be transferring substantial wealth offshore for the benefit of [redacted] of the [redacted] family at the Government's expense. The transactions described in this memorandum appear to implicate Federal Gift and Estate tax issues and potential Section 482 issues. We have advised the Examination Team to seek the assistance of local counsel to determine whether other non-Section 41 issues should be perused. Currently, we do not have enough facts to opine on such issues.